



Global Outlook 2024

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LAZARD

2023 gave us:

- The highest inflation and sharpest monetary policy tightening in four decades.
- US resilience as wealth effects and full employment drove consumer spending.
- Weak Chinese growth on the back of a real estate and consumer confidence crisis.
- Lethargy in the Eurozone as rate hikes and export weakness buffeted economies.
- UK stagflation with growth below 0.5% and inflation over 7%.
- Geopolitical turmoil and humanitarian disasters in Ukraine and the Middle East.
- More evidence of climate change as temperatures hit new records.

The outlook for 2024 stands in stark contrast to 2023 with:

- Rate hikes likely shifting to cuts as inflation falls to 2%.
- The Fed engineering a “soft landing” avoiding US recession.
- China sentiment improving despite the ongoing housing overhang.
- The Eurozone and UK teetering on the brink of recession as sticky inflation precludes easing.
- Japan exiting yield curve control and negative interest rates.
- The Ukraine war dragging on and Western tensions with China ratcheting higher.
- US elections becoming the focal point as a determinant of the geopolitical trajectory.

In 2023, US growth surprised on the upside as consumers depleted much of the over

US\$2.25 trillion

of excess savings accumulated during the pandemic

Introduction

The global economic landscape is in flux. The sharpest monetary policy tightening in four decades slowed growth less than expected, but long and variable lags between policy changes and economic impact suggest recession risk remains pronounced.

In recent decades, the United States and China have been the two primary economic locomotives. In 2023, US growth surprised on the upside as consumers depleted much of the over \$2.25 trillion of excess savings accumulated during the pandemic. Going forward, consumers will increasingly rely on wage gains and, to a lesser degree, Federal Reserve easing to support spending.

Growth in China faltered as the housing sector, which comprises nearly a quarter of GDP, fell into crisis. This led to a raft of stimulative measures announced by various levels of government, which should lift prospects next year.

Stagflation plagued the Eurozone through much of 2023, but conditions are likely to improve in 2024 as disinflation progresses. Unfortunately, recession appears likely, with 3Q23 data showing a 0.1% contraction in Eurozone real GDP, with Germany and other industrially intensive economies weighing on the region's output, while more service-driven economies outperform.

Japan is the outlier as the only developed economy maintaining negative interest rates. I expect Japan to continue growing above potential through 2024 as the Bank of Japan (BoJ) seeks to avoid snatching defeat from the jaws of victory in its battle against deflation.

The highest geopolitical risk in decades has compounded economic uncertainty. Between ongoing war in Ukraine, a humanitarian disaster in the Middle East, and rising tensions between China and the West, executives and investors can no longer assume a placid geopolitical backdrop when making decisions.

While predicting the course of any single geopolitical crisis

is fraught, what is clear is that the global trajectory is toward more frequent conflicts of increasing consequence. Navigating the evolving—at times treacherous—geopolitical landscape will likely require access to deep wells of expertise, as geopolitical issues that could have been ignored in the past now stand to directly impact companies' supply chains and customer bases.

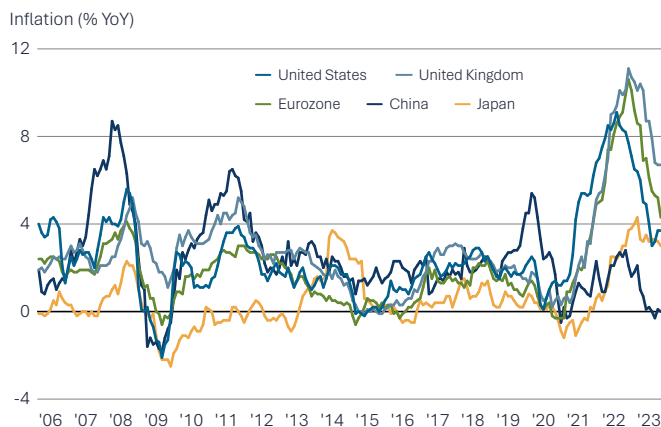
Global Inflation and Growth

Both headline and core inflation are likely to continue subsiding through 2024. Energy prices have largely driven the fall in headline inflation to date. After Russia invaded Ukraine, energy inflation topped 40% y/y in the Eurozone and United States, and reached 59% in the United Kingdom. Energy prices have declined since to levels in line with the prior year implying zero contribution to headline Consumer Price Indexes (CPI).

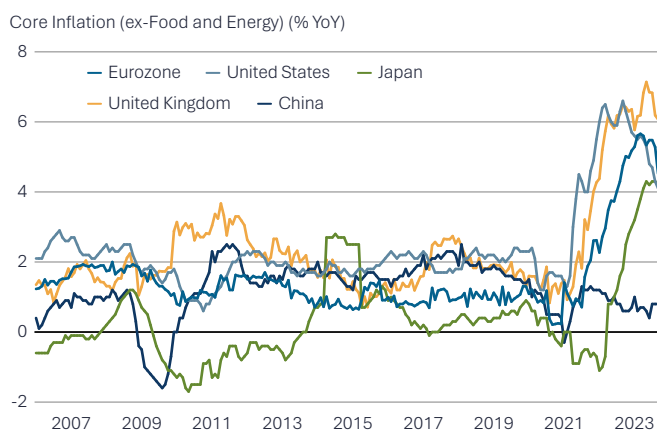
Dissipating energy inflation (which might not be sustained) occurred alongside the elimination of supply chain bottlenecks and semiconductor shortages; these combined with a surge in demand to cause the spike in core goods prices in 2021 and 2022. Fed analysis indicates supply chains are in better shape now than before the pandemic which has fed into lower core CPI. US core CPI has fallen from a peak of 6.6% to 4.1% and is likely to fall further as shelter inflation decelerates. In the Eurozone, core inflation declined from 5.7% to 4.5%, while UK inflation has fallen from 7.1% to 6.1%.

Despite still-elevated core inflation, I believe the Fed, European Central Bank (ECB), and Bank of England (BoE) have finished their rate hike cycles. While one more hike is possible, from current levels a 25 basis point (bp) rate hike is not very impactful. What is more important is how long rates remain elevated. Consumers and companies have been able to withstand higher rates so far, but the brunt of the rate increases really occurred in the

Headline Inflation Has Peaked across Developed Economies



Core Inflation: Japan at Peak, Eurozone, UK, and US Falling

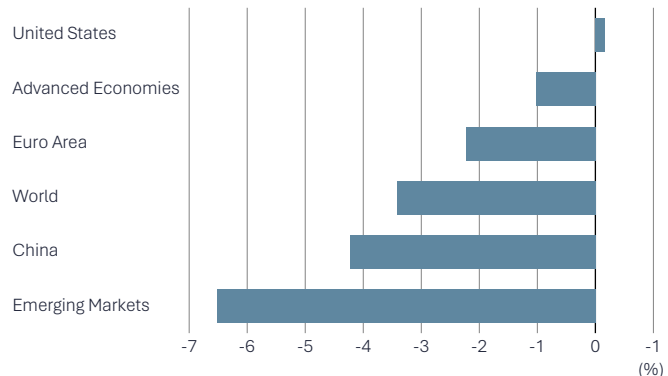


last 15 months. Historically, economists assume it takes about 18 months for monetary policy changes to fully materialize in the real economy, which implies additional stress could be ahead.

The battle against inflation is not won, but the tide has turned in favor of central banks. The cost of this victory has been economic deceleration. While the US finds itself in a stronger position in 2023 than prepandemic projections implied, the rest of the world has not fared so well. Advanced economies are between one and two percentage points smaller than implied by prepandemic trends, largely because of the lack of fiscal latitude to intervene as the United States did.

According to the International Monetary Fund (IMF), global fiscal stimulus measures from January 2020 through April 2021 totaled US\$10.8 trillion, of which US\$5.3 trillion was spent in the United States. This implies that ~50% of global stimulus was deployed on behalf of just over 4% of the world's population. US fiscal stimulus was nearly matched by a US\$4.8 tril-

Difference between Countries' 2023 Real GDP and the IMF's Prepandemic Projections



lion increase in the Fed's holdings of public debt between the end of 2019 and May 2022. It should be no surprise that the US economy was robust despite the Fed's rate hikes given US\$10 trillion of stimulus.

Looking forward, global growth projections for 2024 are muted, as countries grapple with higher interest rates, shrinking fiscal flexibility, and trade fragmentation. Ongoing geopolitical conflicts and tensions are likely to depress growth further, while adding to inflationary pressures that are beyond the control of central banks. The good news is that sustained disinflation should allow the Fed to contemplate reducing policy rates as early as 2Q24, which should mitigate headwinds to growth and invigorate capital expenditures in anticipation of a cyclical economic rebound.

United States

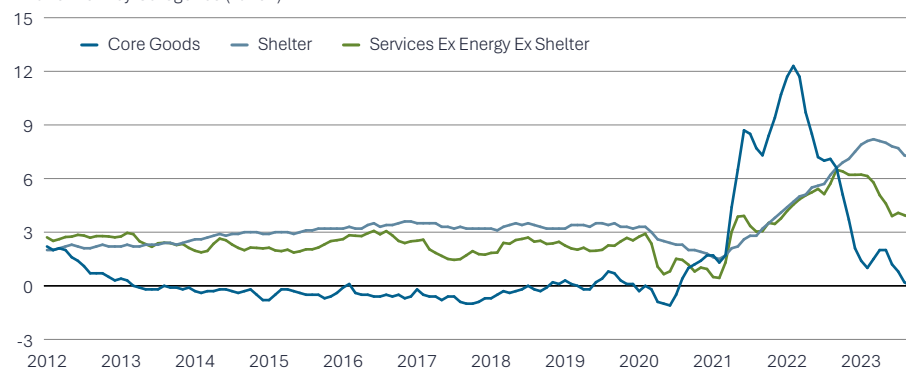
The US economy was far more durable than expected in 2023. The labor market added an average of 239,000 jobs per month, far above the number required to maintain a stable unemployment rate relative to population growth. With disinflation well underway, the United States is entering 2024 in a good position. The key question is when—and how quickly—will inflation return to the Fed's 2% target? The answer will determine how soon the Fed can begin easing policy conditions.

I remain optimistic that US inflation will decelerate relatively quickly based on our assessment of the three key categories within core CPI. Shelter inflation (44% weight) has decelerated from over 16% early in 2022 to only 3% as of September 2023, based on Zillow's Observed Rent Index. This metric tracks asking rents for new leases and hence tends to lead CPI shelter inflation by about one year. Given that the most recent CPI shelter inflation reading exceeded 7%, this component alone gives us confidence that inflation will be materially lower next year.

The second key category is core goods (26% weight) which includes all goods excluding food and energy. Core goods prices

Core Goods Prices Are Falling; Shelter and Other Services Inflation Remain Elevated

Inflation for Key Categories (% YoY)

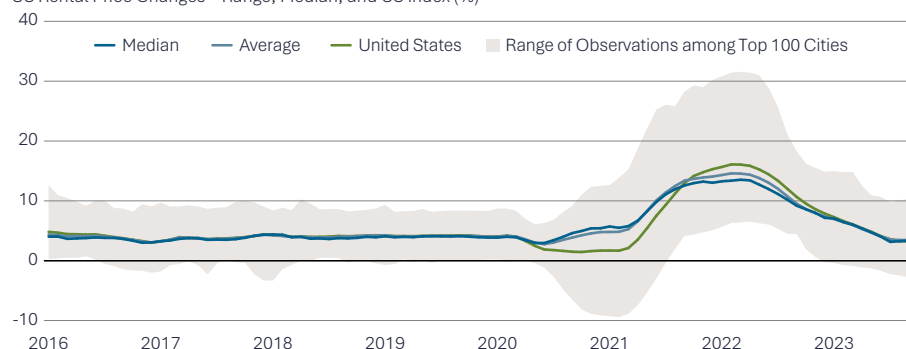


As of September 2023

Source: Bureau of Labor Statistics, Haver Analytics

US Rent Inflation Has Fallen from 16% to 3%

US Rental Price Changes – Range, Median, and US Index (%)



As of September 2023

The Index covers the largest cities in the United States beginning in 2015. Shaded gray area shows range from the lowest rent inflation to highest among largest 100 cities in the Index.

This index captures asking rents (not agreed rents) for new leases only (not including renewals).

Source: Zillow.com Observed Rent Index

have been declining, including a sizable 40bp decline in the month of September alone. The recent news that the United Auto Workers (UAW) strike is likely over increases our confidence that core goods prices will remain tame, or even continue declining in 2024.

The third category in core CPI is services excluding shelter and energy services (30% weight). This category is driven primarily by labor costs. Normalization in the labor market appears to be underway as the number of unfilled jobs has declined from 2.0 per unemployed worker to 1.5 since July 2022. At the same time, the voluntary quit rate has declined from a record high 3.0% per month to 2.3%, in line with the two years before the pandemic.

The Fed appears to be successfully navigating a soft landing in which unemployment rises only marginally, while labor market tightness fades as demand for labor weakens. If the labor market continues its current trajectory, I expect core CPI to reach 2% in the second half of 2024, which should allow the Fed to cut rates in anticipation of that landing.

On top of the good news on the inflation front, 2024 might represent an economic inflection point if the Biden administration's industrial policy can create competitive, export-based industries. Landmark pieces of US legislation—such as the bipartisan Infrastructure Investment and Jobs Act in 2021 and the Inflation Reduction Act (IRA) and the CHIPS

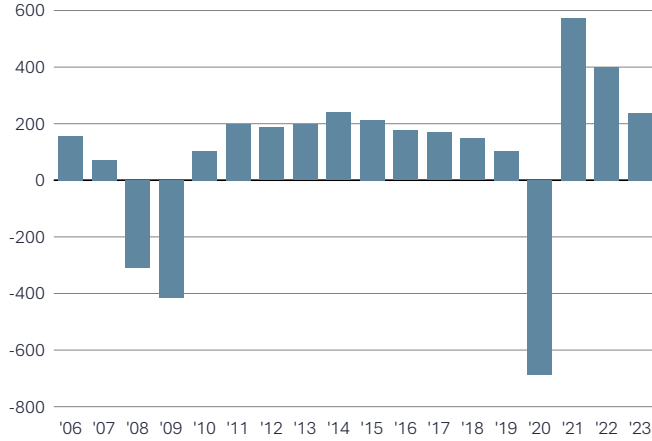
In the United States, the labor market added an average of

239,000

jobs per month through October, far above the number required to maintain a stable unemployment rate relative to population growth

The US Is Creating More Jobs than Are Required to Maintain Stable Unemployment

Average Monthly Change in Private Nonfarm Payrolls (Thousands)

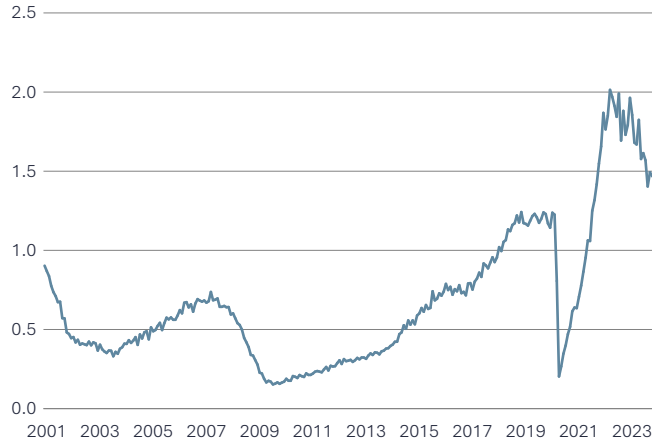


As of September 2023

Source: Bureau of Labor Statistics, Haver Analytics

Labor Market Tightness Is Easing: 1.5 Unfilled Jobs/Unemployed Worker

US Unfilled Jobs per Unemployed Person (Ratio)



As of September 2023 for unfilled positions. As of October 2023 for unemployed workers.

Source: Bureau of Labor Statistics, Haver Analytics

Act in 2022—are expected to add to productivity growth over a multi-year period as government incentives stimulate increased private sector investment. The IRA is likely to surprise on the upside with the Brookings Institution and Goldman Sachs both independently estimating that total funding under the IRA could reach US\$1 trillion as companies rush to capitalize on subsidies intended to establish the United States as a leader in the energy transition.

Yet, downside risks remain. Access to credit could become increasingly constrained. Ongoing challenges in the commercial real estate market and the increased cost of funding for banks are likely to feed into tighter underwriting standards and higher-cost financing for consumers and companies who can still obtain credit. If monetary policy still works with long and variable lags, it would be premature to declare this an “immaculate disinflation.” A recession is no longer our base case, but if one does occur in 2024, the economy is in a strong position, suggesting a short and shallow downturn.

A second key risk to the US economy is ongoing political dysfunction. While Congress averted a government shutdown and, more critically, avoided default by raising the debt ceiling until January 2025, the ousting of Kevin McCarthy as Speaker of the House—and the subsequent three-week period without a replacement—suggests there may be further political volatility ahead. While I agree that US fiscal deficits are on an unsustainable trajectory, the solution is not default or shutdowns; it’s bipartisan compromise that addresses the structural deficiencies of current spending and tax policies.

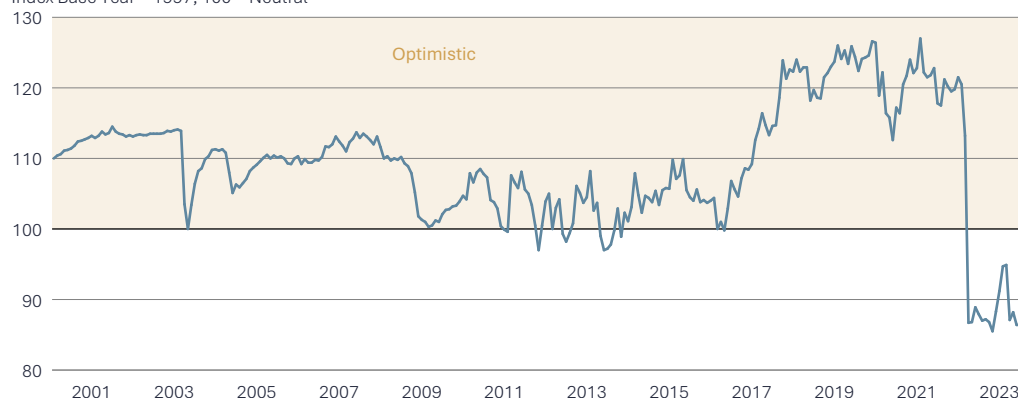
Finally, the 2024 US election could be a watershed moment geopolitically, as further aid to Ukraine hangs in the balance along with foreign policy predictability and rule of law. Many investors assume the United States will always have the reserve currency of the world and enjoy the “exorbitant privilege” that comes with such status, given the absence of obvious alternatives today. I would caution against such presumptuousness. The United States derived its reserve currency and safe-haven status by proving the resiliency of its institutions, developing a democracy that was largely a question of shades of gray rather than extreme binary choices, and through consistently applied rule of law. The United States also benefited from the absence of viable alternatives after World Wars I and II decimated competitors’ economies. Increasingly, consumers, companies, and countries have more choices. No one should presume that the United States is entitled to exceptional status without earning it.

Shelter inflation in the United States decelerated from

16% to **3%**
in 2022 as of September 2023

Chinese Consumer Confidence Remains in the Doldrums

Index Base Year = 1997; 100 = Neutral



As of September 2023

Source: Bloomberg, National Bureau of Statistics of China

China

Many observers expected the post-COVID reopening of China to boost global growth in 2023, only to see that optimism quickly dashed. Consumers did return to restaurants and cinemas, but they largely refrained from big ticket purchases. Consumer confidence data highlighted this negativity.

The root cause of the economic lethargy are problems in the real estate industry which have affected property developers and municipal finances, and have ultimately contaminated the broader

economy. Real estate comprises between 15% and 30% of China's GDP depending on how expansively the sector is defined. If we split the difference and say real estate development and directly related services comprise 20%–25% of GDP, it is clear real estate is vital to China's economic well-being. As importantly, for the median household in China, real estate typically comprises 60%–70% of assets, meaning housing prices have a major impact on psychology.

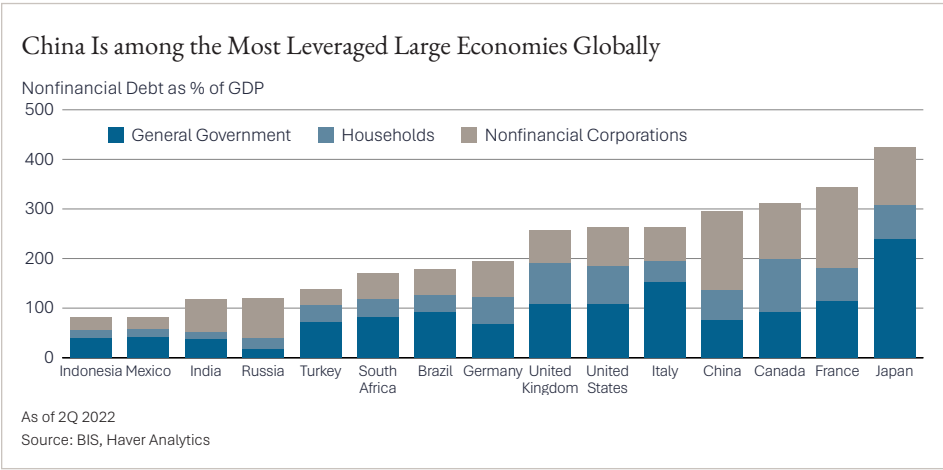
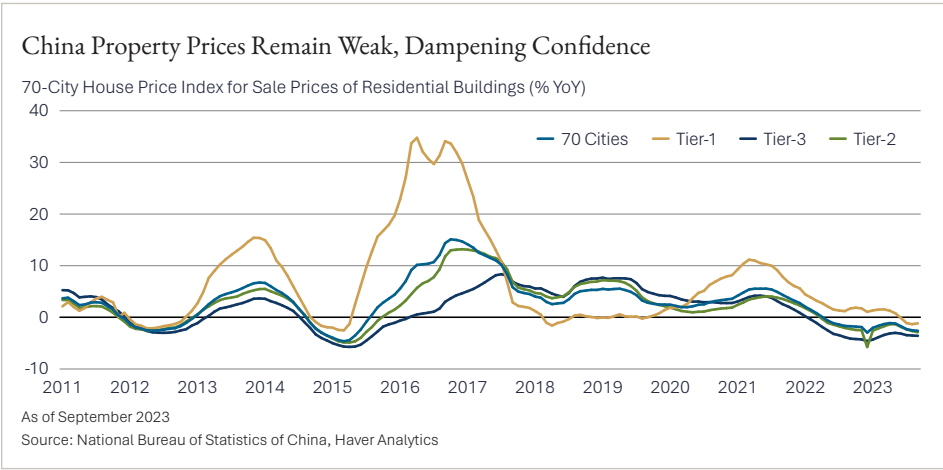
From 2000 to 2010, about 18 million new housing units were developed each year in China as urbanization shift-

ed the population from rural areas to cities and as the housing stock was upgraded to reflect higher incomes and assets. However, along the way, the new supply began to exceed real economic demand. The gap was largely filled by speculators who had only experienced one trend through time: rising home prices. Ultimately, the central government cracked down on developers by enacting a "three red lines" policy that limited leverage in the sector and shut off financing. This began the current real estate developer crisis. The government also launched verbal attacks

on speculators, with Xi Jinping repeatedly noting that "housing is for living, not for speculation" as the cost of housing was creating social tensions.

As lack of credit began to bite, privately owned real estate developers encountered financial difficulties that made delivering presold homes challenging. About 50% of the largest private developers have now defaulted on their debts, causing consumers to lose confidence in developers and in the idea that home prices always go up.

This negative view on house prices is not easy to validate in publicly reported indices. For example, the popularly referenced 70-City House Price Index in China captures new home prices in Tier 1, 2, and 3 cities. However, the index does not accurately portray reality. When developers gain approval to market a new housing complex, they typically set the price in agreement with local authorities and cannot change those headline prices afterward. Developers can offer bonus amenities such as a free parking spot or credits to buy appliances, but they cannot cut prices. This means



Chinese Authorities Have Announced Numerous Stimulative Measures

Stimulus	Details
Mid-year Fiscal Deficit Adjustment	CNY 1tn central government bond issuance to fund local government rebuilding in disaster hit areas and improve urban drainage and flood prevention
PBoC rate cut	The PBoC's one-year medium-term lending facility was cut by 15bps in August, to 2.5%, the largest since 2020, and the second cut in 2023
PBoC Bank Reserve Requirement Ratio Cut	Cut Reserve Requirement Ratio (RRR) twice (-25bps in March and -25bps in September) leaving weighted RRR at 7.4% and freeing ~\$69bn for lending
Housing markets and local banks	- Banks have cut rates on up to \$5.3tn of existing mortgages in Tier 1 and 2 cities - Tier 1 cities lowering mortgage requirements and purchase curbs to increase home sales - Relaxation of home purchase restrictions and down payment reductions in Tier 1 cities
Financial markets	- Increasing support of the Yuan, as PBoC issued verbal warning about trading levels and committed in July to keep the Yuan stable around 7.3 RMB/USD - Lowered stamp duty on stock trades in August to bolster equities market. Securities regulator slowing IPOs and encouraging buy-backs
Consumption support	Consumption support package, including rural e-commerce expansion, cheaper home renovation services, tax exemptions on EV purchases, and more

As of November 2023

that the reported 2%–5% price declines in the 70-City House Price Index do not reflect the discounting that is occurring. We have learned that in secondary markets, home prices are now down 15%–20% in Tier 1 cities and 30% or more in lower tier cities, signaling a significant hit to consumer net worth and a much more dire story than public data imply.

Fortunately, this does not mean China faces a US-style housing bust or a financial crisis, as regulations on loan-to-value ratios are much stricter in China than US rules in 2005–2008. As such, even with home prices down 15%–30%, homeowners in China still have (sizeable) equity cushions and remain in the black. However, this loss of net worth still does not bode well for consumption and confidence.

Initially, the Chinese government watched passively as the economy faltered, but in the second half of 2023, the authorities launched dozens of measures to prop up the economy and to increase demand for housing, including for investment properties. In October, the central government announced a mid-year revision to the central government budget and fiscal deficit target for the first time since the Asian Financial Crisis in 1998–2000. The decision to issue CNY 1 trillion of incremental central government debt to fund local government spending might be the most important measure so far. While I do not expect a flood of credit stimulus due to China's elevated debt levels relative to other large economies, I do believe we will see continued steps to ensure a minimum level of growth into 2024.

Overall, I believe sentiment regarding China has gotten too negative, given the array of recent stimulative measures and the sharpness of the decline in new housing construction, which has already occurred and will likely lead to stabiliza-

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tion in building activity in 2024. Moreover, there are signs of consumer confidence and spending bottoming, suggesting near-term improvement is at hand.

Another positive is that China has become the largest exporter in critical strategic sectors like electric vehicles (EVs) and solar and wind power. In EVs, for example, China went from a net importer in 2019 to the largest net exporter in 2023. Similarly, China has embedded itself within the renewable energy supply chain, which should lead to growing Chinese exports as demand for components grows. By positioning itself as the low-cost producer in high-growth sectors of the global economy, China has likely secured additional growth for years to come, even if it might be blocked from US markets in some cases.

Finally, since mid-2023 the US-China relationship has begun to thaw. While anti-China hawkishness is bipartisan and firmly entrenched in the United States, the Biden administration has sought to ease relations, with multiple members of the US government visiting Beijing before year-end. The likely meeting of President Biden and President Xi before the end of 2023 could open the door for a near-term reprieve in trade relations.

One of China's biggest long-term problems remains that it is too focused on investment, and not enough on domestic consumption. There are some signs that this is changing. In 2022, a greater share of Chinese bank loans went to the industrial sector instead of real estate, for the first time in two decades. However, the fundamental model that has brought China success since the 1990s is running out of steam. The Chinese economy is not constrained by too-low savings—as is common for lower income countries—but by savings that are too high. Yet the Chinese government seems unwilling to shift from this model, and the longer this goes on, the more disappointing China's growth will be. One way to shift the model would be by implementing a more robust social safety net that gives households the confidence they need to sustain consumption even in times of economic stress or as they age.

Eurozone

In the Eurozone, the good news is that inflation has peaked. The bad news is that with the absence of fiscal stimulus of a scale seen in the United States, hits from the Ukraine-driven energy price shock, and ECB interest rates hikes, the Eurozone economy is teetering on the brink of recession. I place the odds of recession in the Eurozone at about 50% over the next 12 to 18 months, with recession potentially already underway given the 3Q23 GDP reading of -0.1% quarter-over-quarter.

Interest rate transmission in the Eurozone is swifter than in the United States as over 70% of Eurozone corporate funding is from banks (often at floating rates) versus ~80% of US corporate funding from debt markets (largely at fixed rates). Rising interest expenses and sharply higher fuel prices hit Germany hardest, with industrial production for the energy-intensive portion of the economy now 15% below the level of 2015. The winter of 2022–2023 was unusually warm, but there is no guarantee this winter will be as kind, which could lead to more pressure on industrial output.

Europe has made progress in weaning itself off Russian energy, but this process will take years. Fortunately, there is momentum to increase energy independence by constructing LNG terminals, raising investment in nuclear power, and doubling renewable energy as a share of EU consumption to 42.5% by 2030. These measures, combined with carbon pricing, border adjustment taxes, and specific industrial policies, should improve Europe's energy competitiveness over time.

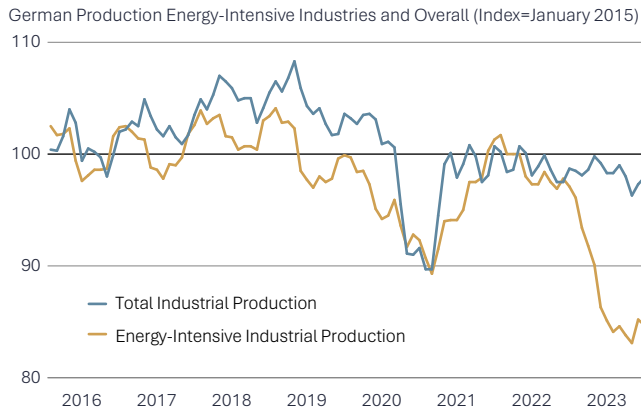
Consumer confidence has also suffered in the Eurozone, with war on its doorstep compounding the financial challenges facing the region. Retail sales in the Eurozone remain below the prepandemic trend while US sales are well above. European real income is improving as disinflation continues, but we have not yet seen that translate into increased confidence and consumption. Moreover, even a short-term improvement in real income will not reverse the widening income gap that

Interest rate transmission in the Eurozone is **swifter** than in the United States as over

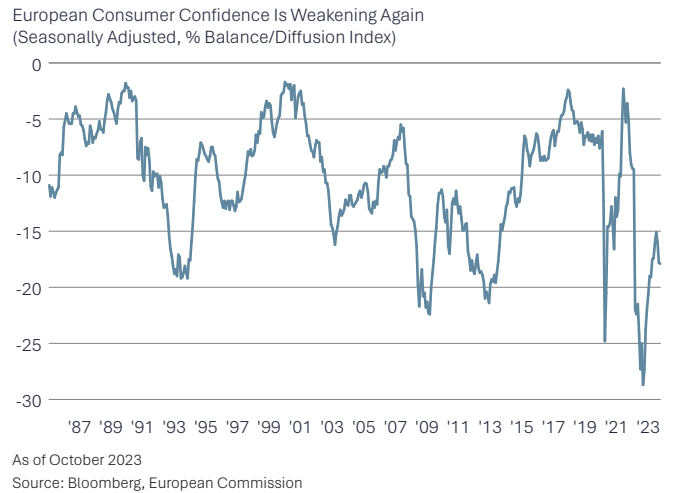
70% ▲

of Eurozone corporate funding is from banks

Energy-Intensive Industries in Germany Suffer from Higher Energy Costs



European Consumer Confidence is Weakening Again

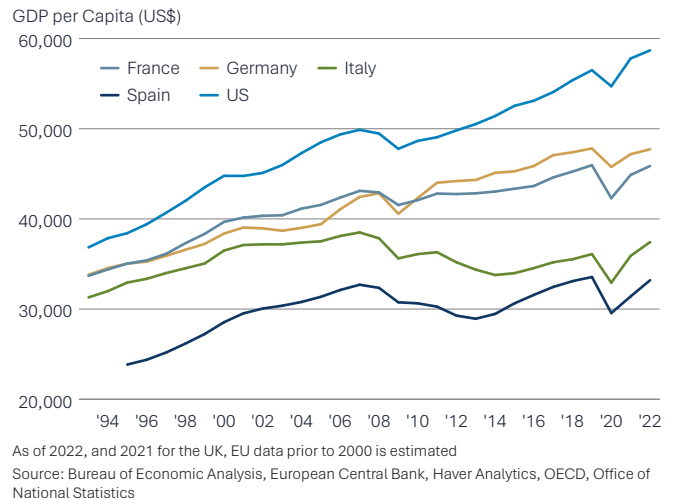


has opened between the United States and Europe. In 2002, US per capita income (in 2010 USD) was 12% higher than in France and 16% higher than in Germany. By 2022, US real per capita income had grown 30% and was 28% higher than in France and 23% higher than in Germany. The ongoing relative stagnation of the European economy is not lost on consumers, as shown in confidence data.

As with the Fed, I believe the ECB rate hike cycle is over. Eurozone disinflation is not as well progressed, but as recession risk rises and inflation slows, I expect the ECB to remain on hold and allow measures already taken to have their effect. Unlike the Fed, I do not expect any rate cuts from the ECB until 2H24 as the single price stability mandate precludes the ECB from easing rates to raise employment.

Another risk in 2024 is political. Ongoing economic stagnation combined with elevated immigration, driven by wars in neighboring regions, could lead to rising support for extremist political parties. Ironically, Europe may need more young skilled immigrants at precisely the time that anti-immigrant sentiment is rising. Given that the European Union's median age is 44.4 years old versus the United States' at only 38, either raising birth rates or increasing immigration would help mitigate rising dependency ratios. Unfortunately, the current landscape is not conducive to such policies.

US GDP per Capita Meaningfully Surpasses that of European Peers



Energy-intensive industrial production in Germany

is now **15%**
below the level of 2015

Japan

Through the second half of 2023, the BoJ significantly curtailed its policy of yield curve control (YCC) by progressively widening the permissible trading ranges for long-dated Japanese Government Bonds (JGBs). In 2024, markets will watch for a formal end of YCC and then the focus will shift to when the BoJ ends its negative interest rate policy (NIRP). While other advanced economies have been tightening monetary policies, the BoJ has been hoping to take advantage of price pressures and reflate the economy. There are some signs this is working: Japanese real wages are growing, and the labor market is tight. Given Japan's deflationary record, inflation is welcome, and so far, it seems healthy.

The decision over when to end NIRP will largely depend on the BoJ's assessment of the sustainability of inflation, which is contingent on ongoing wage growth. The key shunto negotiations for labor in Japan occur in the spring, but the Japanese Trade Union Confederation (known as Rengo) has indicated it is seeking a wage increase of at least 5% in 2024. Based on analysis of past wage requests versus realized gains, the indication for 2024 suggests wage growth will be sufficient for the BoJ to consider ending NIRP. Actual results of the shunto will not be available until April or May, but the BoJ seems unlikely to wait for the news if inflation remains near current levels.

The BoJ is hoping it can exit NIRP without disrupting the financial system and the economy. One concern for Japan

is that if it does convince markets that inflation will remain at 2% for the foreseeable future, there could be an interest rate shock, as investors would be unlikely to buy a 10-year JGB at a yield of less than 1% with inflation at 2%. If 10-year yields were to rise to a level that not only compensated for inflation but also included a term premium, one could imagine a 2.5%–3% yield that would imply large unrealized losses on bond portfolios held by banks and the BoJ itself. The key to such an interest rate adjustment would be the amount of time it takes to occur. If the BoJ could choreograph a rise in rates over multiple years, securities would mature at par and be replaced by higher-yielding assets, helping banks earn their way out of the bind. However, markets rarely behave this way, which raises the risk that the BoJ can only go so far in allowing markets to determine rates.

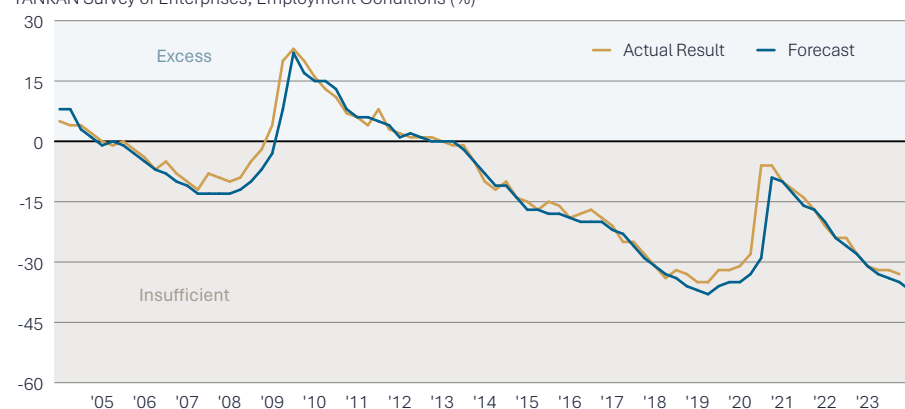
The alternative of maintaining excessively easy monetary policy could mean further yen weakening, which imports more inflation into Japan and ultimately requires a response. Exiting YCC is less risky than ending NIRP in my view, but the challenge in markets is that the end of YCC will be viewed as the beginning of the end of NIRP. The bottom line is that the BoJ has a serious challenge on its hands.

Another important topic to watch in Japan in 2024 is the ongoing governance shake-up instigated by the Tokyo Stock Exchange (TSE). The TSE now requires companies whose shares trade below book value for a prolonged period to publicly announce how they plan to resolve the issue, or face delisting. When the policy was announced, ~50% of all companies trading on the TSE were trading at or below book value. The policy change has led to record levels of share buybacks and increased dividend payments as companies strive to avoid this ignominious outcome. I expect this ongoing optimization of capital allocation to lead to a more dynamic corporate sector in Japan.

The biggest long-term problem for the Japanese economy remains demographics. Shinzo Abe's government successfully promoted both greater female labor force participation—which rose

Japan's Labor Market Remains Extremely Tight

TANKAN Survey of Enterprises, Employment Conditions (%)

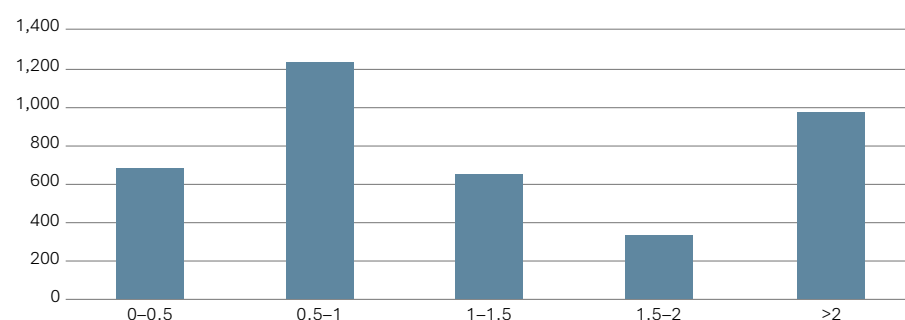


As of September 2023

Source: Bank of Japan, Haver Analytics

~50% of All Stocks in the TSE Traded Below 1x Book at the End of 2022

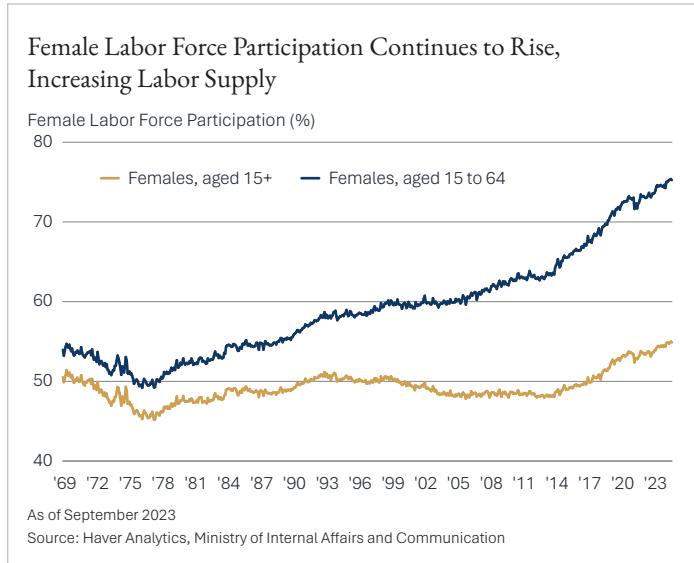
Histogram of Distribution of Price-to-Book Ratios for Members of the Tokyo Stock Exchange (Frequency)



As of 31 December 2022

Source: FactSet

10 percentage points since 2013 for women aged 15 to 64—and increased immigration on the margin. While these moves helped, immigration remains far lower than it would need to be to ensure long-term stabilization of inflation and growth. It is notable that GDP per capita in Japan has grown in line with that of the United States over the last decade, but with a rapidly shrinking population, Japan's total GDP continues to decline, especially in US dollar terms given the depreciating yen.



Geopolitics

Three geopolitical hotspots are likely to remain focal points into 2024: Russia-Ukraine, Israel-Hamas, and China-Taiwan.

The Russia-Ukraine conflict has already shown that it can disrupt global markets, and I expect it to extend well into 2024 as the Ukrainian counteroffensive appears near an end, due to the

approaching winter and concerns over the reliability of Western funding and artillery. Time is on Russia's side given the quantitative advantages of a much larger economy, population, and store of weapons, not to mention the ability to produce more weapons in a secure homeland. While a negotiated settlement is likely the only way to end the war, both sides remain far from the point of agreeing to capitulate on their grand designs—that is, for Russia to control all of Ukraine and for Ukraine to control all of its sovereign territory.

The conflict between Israel and Hamas is already a humanitarian tragedy, both in terms of the barbaric terrorist attack by Hamas that murdered over 1,400 civilians, and increasingly, the Israeli efforts to eliminate Hamas in the confines of a densely populated territory where thousands of innocent civilians have already died. To date, the conflict has not spread beyond Israel and Hamas other than skirmishes on the northern Israeli border with Hezbollah and isolated incidences in the West Bank between Israeli settlers and Palestinians.

The more combustible situation would be expansion to include states such as Iran. This could spiral into a regional conflict with global economic and military implications. Any escalation that involves Iran would likely also encroach on the safe transit of energy supplies through the Strait of Hormuz through which about 20.5 million barrels of oil per day (~20% of global supplies) are shipped. Any threat to this vital shipping lane could have dramatic global economic consequences.

In the near term, all parties—Iran, the United States, and Israel—have strong incentives to keep the conflict limited. While the humanitarian impact will be devastating both in Gaza and for victims of terrorism in Israel, I think it unlikely that there are major market impacts in the short term.

Finally, the most economically consequential geopolitical tensions relate to China. The friction between China and the West is multi-faceted, with Taiwan as a near-term focal point. Early 2024 Taiwan elections will set the stage for the rest of the year. The Democratic Progressive Party (DPP) is currently well ahead of the



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more Beijing-friendly Kuomintang (KMT). A DPP victory would likely escalate tension with Beijing as the DPP is seen as favoring a formal declaration of independence, a red line for the Chinese government.

Chinese air incursions into Taiwan's air defense identification zone (ADIZ) increased from 380 in 2020, to 972 in 2021, to 1,737 in 2022, and to 1,476 through 30 October 2023. As China's military increasingly agitates the island state and other neighbors in the South China Sea, support for arming and defending Taiwan has increased in the United States. One key risk in the region is that China has to date refused to establish military hotlines or other measures to avoid escalation, as the Chinese leadership fears that facilitating such communication almost encourages future US intervention. As such, the world will watch the results of the February Taiwanese elections carefully for signs of whether the situation might escalate further, or head in a more benign direction.

One clear impact of both direct competition between the US and China and China's ambitions over Taiwan is supply chain fragmentation. Trade tariffs and barriers, combined with concerns over supply chain disruptions during the pandemic, have led more advanced economies to pursue "friendshoring" or "nearshoring" strategies. These plans are proving more difficult than policymakers might have envisioned, given inertia around supply chains and the challenge of cultivating the necessary skills among workers in new locales. Still, geopolitical tension is contributing to economic fragmentation which, at least in the short run, may dampen global growth and contribute to inflationary forces.

Conclusion

The past five years have upended economies globally, as the pandemic resulted in unprecedented monetary and fiscal stimulus policies, followed by decades-high inflation, and the sharpest monetary policy tightening in 40 years. The riskiest geopolitical circumstances in decades compounded this sense of upheaval. The outlook is not rosy, but it's also not bleak.

Disinflation is underway and developed market central banks have likely finished their rate hike cycles. In our view, while rate cuts are not imminent, the next leg of this cycle will likely be policy easing. As economies recalibrate to higher interest rates, growth will normalize, but the operating backdrop will not return to one of zero rates and persistently low inflation. Instead, companies and investors will likely have to adapt to a new operating environment in which fundamental analysis will regain prominence after years of negative real interest rates led to macro assumptions trumping company-specific factors.

With the added dimension of geopolitical uncertainty, executives and investors will also likely need to seek expert advice on how to navigate risks and opportunities that don't lend themselves to free cash flow models, but instead are more at home in a tail-risk stress test. Structural economic and geopolitical inflections are unsettling, but they may also create opportunity for the executives and investors who recognize the shifting landscape and prepare for the new backdrop. 2024 might present just this opportunity.

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